UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
SOUTH BEND DIVISION

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| IN THE MATTER OF | ) | |
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| REBECCA ANN LEKARCZYK, | ) | CASE NO. 01-35838 HCD |
| | ) | CHAPTER 7 |
| | ) | |
| DEBTOR. | ) | |

Appearances:

Steven J. Moerlein, Esq., attorney for debtor, Moerlein Law Offices, 218 W. Washington St., Suite 630, South Bend, IN 46601; and

Juliana G. Robertson, Esq., attorney for creditor, 9247 North Meridian, Suite 215, Indianapolis, Indiana 46260.

MEMORANDUM OF DECISION

At South Bend, Indiana, on February 20, 2003.

Before the court is the Motion to Avoid Lien filed by the debtor Rebecca Ann Lekarczyk ("debtor") on February 19, 2002. The debtor sought to avoid a nonpossessory, nonpurchase-money security interest in household furnishings held primarily for personal, family or household use. The creditor Personal Finance Company ("PFC" or "creditor") filed its Objection to Motion to Avoid Lien on March 4, 2002. After a hearing and briefing on the matter, the court took the matter under advisement on August 17, 2002. For the reasons that follow, the court grants the debtor's motion.

Jurisdiction

Pursuant to 28 U.S.C. § 157(a) and Northern District of Indiana Local Rule 200.1, the United States District Court for the Northern District of Indiana has referred this case to this court for hearing and determination. After reviewing the record, the court determines that the matter before it is a core proceeding within the meaning of § 157(b)(2)(B) over which the court has jurisdiction pursuant to 28 U.S.C. §§ 157(b)(1) and 1334. This entry shall serve as findings of fact and conclusions of law as required by Federal Rule of Civil

Procedure 52, made applicable in this proceeding by Federal Rule of Bankruptcy Procedure 9014. Any conclusion of law more properly classified as a factual finding shall be deemed a fact, and any finding of fact more properly classified as a legal conclusion shall be deemed a conclusion of law.

## Background

The debtor filed her voluntary chapter 7 bankruptcy petition on November 19, 2001. She now seeks to avoid PFC's lien on furniture — a chaise rocker and sofa – that she purchased from Value City Furniture on July 31, 2000. The facts, based on documentation proffered by the parties, are not contested. The debtor financed the $912.41 purchase of the furniture by entering into a retail installment contract that was assigned to PFC. *See* R.11, Ex. A (Retail Installment Contract). On October 30, 2000, the debtor executed a promissory note in favor of PFC in the principal amount of $1,885.30, plus interest at the rate of 31.04%. *See* R.11, Ex. B (Promissory Note, Disclosure Statement and Security Agreement).[1] From those proceeds, $706.40 was used to pay off the original contract for the furniture purchase. The note established payments of $81.11 over a period of 36 months. It granted to PFC a security interest in the collateral and filed a Uniform Commercial Code Financing Statement (UCC-1), which was recorded in the office of the St. Joseph County Recorder. *See id.* The financing statement specifically listed the chaise rocker and sofa as collateral. According to the debtor, the balance remaining on the second loan when her motion was filed was $1,685.06.

The debtor, in her motion and brief, insisted that she paid off the original loan in its entirety with the funds from the second loan. Her position was that the furniture became nonpossessory, nonpurchase-money collateral when she borrowed additional money from the creditor and used part of it to pay off the original note. According to the debtor, the money borrowed from PFC in the second loan did not represent any part of the

[1] The Promissory Note sets forth an itemization of the amount financed: $706.40 to lender, credited on account number 660005; $11.00 to St. Joseph County Recorder; $56.94 Credit Life Insurance, to insurance company; $110.96 Credit Disability Insurance, to insurance company; and $1,000.00 given to the borrower Ms. Lekarczyk directly. The total amount financed therefore, was $1,885.30.

purchase money used to buy the items covered in the security agreement. She sought to avoid the lien on the debtor's personal property because it impaired the bankruptcy exemption to which she was entitled. The debtor relied on *Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy)*, 3 B.R. 454 (Bankr. S.D. Ind. 1980), a case with facts similar to the ones before this court.

The creditor objected. It claimed that the furniture purchase was a purchase money transaction under Indiana law and that the second note, executed in favor of PFC, granted PFC a security interest in the furniture as collateral. The creditor pointed out that it filed a UCC filing statement evidencing the second loan agreement. PFC acknowledged that the debtor paid off the first note with funds from the second note. It argued, however, that its lien did not impair the debtor's household or personal goods exemptions and was not a lien that could be avoided under Indiana law. It requested that the debtor either reaffirm the debt or surrender the collateral.

On May 23, 2002, the court conducted a hearing on the debtor's motion to avoid the PFC lien and determined that an evidentiary trial was necessary. However, on June 28, 2002, the date of trial, only the debtor's attorney appeared; counsel for the creditor did not attend. The court directed the parties to file a stipulation of facts within ten days. It then set forth a briefing schedule. The parties filed their Stipulation of Facts and Stipulation of Legal Issue on July 9, 2002. The debtor filed a brief, "Movant's (Debtor's) Brief in Support of Motion to Avoid Lien," on July 19, 2002. The creditor did not submit a brief. Once the briefing period had passed, the court took the debtor's motion and creditor's objection to it under advisement.

## Discussion

The parties have submitted to the court one legal issue for resolution: whether Indiana's opting out of the federal bankruptcy exemptions of 11 U.S.C. § 522 precluded the debtor from utilizing § 522(f) to avoid the creditor's lien.

The court finds that the debtor was not precluded from seeking to avoid PFC's lien under § 522(f) because of Indiana's opt-out provisions. The Bankruptcy Code, which intends to give a debtor a fresh start after bankruptcy, allows a debtor to retain basic household necessities by exempting from his or her bankruptcy estate certain types and amounts of property. *See* 11 U.S.C. § 522(d) (providing list of federally exempted property); *Associates Fin'l Servs. Co. v. Boldman*, 495 N.E.2d 203, 205 (Ind. App. 1986) (explaining Congressional intent in establishing bankruptcy exemptions, citing H.R. Rep. No. 595 at 127, *reprinted in* 1978 U.S.C.C.A.N. 6088). However, individual states may choose to opt out of the federal provisions, substituting their own set of exemptions for the federal exemption scheme, and Indiana is among those states opting out.[2] *See* § 522(b); *Citizens Nat'l Bank v. Foster*, 668 N.E.2d 1236, 1238 (Ind. 1996). Nevertheless, the Code does not permit states to opt out of the lien avoidance provisions of § 522(f). A state's power to define its own exempt property (by creating a list which is different from the federal exemptions of § 522(d)) does not include the power to invalidate the federal right to lien avoidance under § 522(f). *See Owen v. Owen*, 500 U.S. 305, 111 S. Ct. 1833, 1838, 114 L. Ed.2d 350 (1991) (holding that liens can be avoided under § 522(f) even when the state has defined the exempt property in such a way as to exclude the property encumbered by the liens); *In re Hatcher*, 131 B.R. 430, 431 (Bankr. S.D. Ind. 1990) ("The United States Bankruptcy Code does not permit a state to 'opt out' of the lien avoidance provisions of 11 U.S.C. § 522(f)."); *In re Greer*, 117 B.R. 422, 425 (Bankr. S.D. Ind. 1990) (finding that § 522(f) allows avoidance of liens in otherwise exempt household goods and that the 1989 amendment to the Indiana exemption statute did not affect the debtors' federal lien avoidance rights). The court concludes,

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[2] In Indiana, the present exemption statute is Indiana Code 34-55-10-2. It has superseded the repealed Indiana Code 34-2-28-0.5. Under the statute, a debtor may exempt from the bankruptcy estate only the property specified as exempt by Indiana law. *See In re Jones*, 768 F.2d 923, 927 (7th Cir. 1985); *In re Berryhill*, 254 B.R. 242, 243 (Bankr. N.D. Ind. 2000). Their right to the exemption is determined as of the date of the bankruptcy petition. *See In re Burns*, 218 B.R. 897, 898 (Bankr. N.D. Ind. 1998). The state statute allows a debtor to exempt real estate or personal property up to $7,500 and tangible personal property up to $4,000. Ind. Code 34-55-10-2(b)(1) and (2).

therefore, that this Indiana debtor may seek to avoid the creditor's lien on her household goods pursuant to § 522(f), notwithstanding Indiana's opt-out provisions.

The court now considers whether the debtor is entitled to avoid the creditor's lien on her furniture under § 522(f). The statute provides, in pertinent part, that "the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is . . . (B) a nonpossessory, nonpurchase-money security interest in any – (i) household furnishings [or] household goods . . . that are held primarily for the personal, family, or household use of the debtor." 11 U.S.C. § 522(f)(1)(B)(i). The parties do not disagree that the debtor's rocker and sofa are household furnishings held primarily for her personal, family or household use. The debate focuses on the nature of the creditor's lien on those goods. It claims a lien under the retail installment contract and the subsequent promissory note.

The court notes first that the retail installment contract (submitted by the creditor as an exhibit attached to its Objection to the debtor's motion) is not legible. The creditor claims that the furniture purchase was a purchase money transaction and that it held a purchase money security interest in the furniture. The debtor does not challenge that characterization of the security interest under the original sales contract.

The Bankruptcy Code defines the term "security interest" as a "lien created by an agreement." § 101(51). However, it provides no definition of "purchase-money security interest." To determine whether a security interest is a purchase-money security interest, therefore, courts turn to the relevant state law for guidance. *See Snap-On Tools Corp. v. Freeman (In re Freeman)*, 124 B.R. 840, 842 (N.D. Ala. 1991). The court finds that, under Indiana law, which has adopted the Uniform Commercial Code and, in particular, Article 9 Section 107, a creditor obtains a purchase-money security interest in collateral "only when one 'gives value to

enable the debtor to acquire rights in or use of collateral if such value is in fact so used.'" *ITT Comm'l Fin. Corp. v. Union Bank & Trust Co.*, 528 N.E.2d 1149, 1154 (Ind. App. 1988) (quoting Ind. Code 26-1-9-107(b)).[3]

The court assumes that the illegible retail installment contract created a purchase-money security interest lien on the property. The actual issue is whether the security interest remained or was extinguished when that contract was paid off with the proceeds from the second loan. "The creditor bears the burden of showing that it has a security interest and the extent of that security interest." *In re Gonzales*, 206 B.R. 133, 135 (Bankr. N.D. Tex. 1997) (stating that, if the creditor fails to prove its security interest, the debtor is entitled to avoid the lien). The creditor, by failing to defend its assertions with citations to authority, by failing to attend the court hearing, and by failing to file a brief, has not shouldered that burden.

However, the court also finds that PFC could not have succeeded, in any case, because under Indiana law it has only a nonpossessory, nonpurchase interest in the collateral that is subject to avoidance under § 522(f)(1)(B). Even if the assignment of the retail installment contract gave the creditor a purchase-money security interest in the chaise rocker and sofa, "that security interest was extinguished by the paying off of the contract with the loan proceeds." *Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy)*, 3 B.R. 454, 456 (Bankr. S.D. Ind. 1980). Once the security interest was paid off and the debtor retained cash from the second loan, there no longer was a purchase-money security interest. *See id.* at 457 ("The authorities are unanimous in holding that if consumer goods secure any price other than their own, and there is no formula for application of payments, the security interest in those goods is not purchase money."). The bankruptcy court's legal analysis in *Mulcahy* follows the case law in Indiana. *See ITT Comm'l Fin. Corp.*, 528 N.E.2d at 1154 (finding that the bank was not a purchase-money security lender because it did not give value to the debtor so that

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[3] The Uniform Commercial Code's Article 9, Secured Transactions, was repealed on July 1, 2001. Section 107 now is found at Indiana Code 26-1-9.1-103. However, because the transactions at issue in this case occurred in 2000, prior to the adoption of the revised provisions, the court finds that the former Article 9 definitions apply. *See, e.g., In re World Auxiliary Power Co.*, 303 F.3d 1120, 1123 n.3 (9th Cir. 2002) (stating that California's revised UCC statute does not affect proceedings commenced prior to July 1, 2001).

he could acquire rights in the collateral; citing cases establishing that a creditor, by refinancing the loan and advancing additional sums to enable a debtor to pay off the debt, destroys the purchase money character of the lien). In fact, *Mulcahy* is consonant with the rulings of many courts across the country.[4] *See, e.g., Matthews v. TransAmerica Fin'l Servs. (In re Matthews)*, 724 F.2d 798, 800 (9th Cir. 1984) (per curiam) ("The vast majority of courts . . . have held that refinancing or consolidating loans by paying off the old loan and extending a new one extinguishes the purchase money character of the original loan, because the proceeds of the new loan are not used to acquire rights in the collateral.") (citing cases).

The court finds that the debtor in this proceeding held the title and interest in the furniture once a portion of the second loan was used to make the final payment on the installment contract. The court also finds that, under the second loan, the collateral secured not only the proceeds that paid the balance on the original contract, but also the insurance costs and new cash to the debtor. Once the collateral secured more than the purchase price, the purchase-money security interest no longer existed; the lien was transformed into an ordinary security interest. *See id.* at 459 (concluding that "the living room furniture secures value other than its own price, and the security interest is therefore not purchase money under Ind. Code 26-1-9-107(b)(1976)"). The court determines that the creditor PFC does not hold a purchase money security interest in the debtor's collateral.

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[4] In general, courts have concluded that, under relevant state law, the purchase-money nature of the original sale was destroyed when the debtor either refinanced the outstanding indebtedness, refinanced the purchase of additional collateral from the original seller and combined the second sale with the original transaction, or used the collateral to secure an obligation other than its purchase price. *See 4 Collier on Bankruptcy* ¶ 522.11[6][b] at 522-90 (Alan N. Resnick and Henry J. Sommer, eds.-in-chief, 15th ed. rev'd 2002) (citing cases). However, other courts have held that a creditor's security interest retained its purchase-money character, under applicable state law, to the extent that the original debt remained unpaid. *See id.* (citing cases). It is noteworthy that the issue of the lien avoidance of refinanced or consolidated purchase-money security interests under § 522(f) is affected under the Revised Article 9. *See* Warner, G. Ray, "Lien on Me: Consumer Avoidance of Non-Purchase-Money Security Interests under Revised Article 9," 20-Nov. Am. Bankr. Inst. J. 22, 23 (2001) ("Indeed, if courts follow the Official Comment [to § 9-103], the question of how § 522(f) applies to refinancing and loan consolidation transactions is open to re-examination.").

The court therefore concludes that the security interest held by the creditor is a nonpossessory nonpurchase-money security interest in household furnishings and is avoidable by the debtor under § 522(f) to the extent of the debtor's exemption.

Conclusion

For the reasons presented above, the court grants the Motion to Avoid Lien of the debtor Rebecca Ann Lekarczyk. The debtor may avoid the lien of Personal Finance Company in the furniture to the extent that her exemption in household furnishings is impaired.

SO ORDERED.

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HARRY C. DEES, JR., CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT

Copy served by United States mail on the following:

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